

**TESTIMONY
ON THE AVAILABILITY
OF AGRICULTURAL AND RURAL CREDIT**

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Thank you for the opportunity to submit testimony, for the record, on "Increasing the availability of agricultural and rural credit" for the Farm Credit Administration's public hearing, August 3, in Des Moines, Iowa.

First and foremost, AgriBank strongly supports the testimony provided by Mr. Ken Auer, CEO of the Farm Credit Council, which urges FCA to finalize the proposal, published in the July 26, 2000 Federal Register, to give all System institutions greater flexibility in purchasing loan participations from non-System lenders. As indicated in Mr. Auer's testimony, loan participations are one of the great success stories of System cooperation with non-System lenders. We see no valid statutory or safety and soundness reason for continuing the excessively narrow wording of the current regulation which, in effect, denies System institutions the flexibility they need to work more closely with non-System lenders. Finalizing this proposed change in the regulations is one simple and direct way of substantially increasing the availability of credit for producers and rural communities.

We also recommend that all Farm Credit institutions be allowed to buy 100% of an eligible note originated by a non-System lender. Recent regulatory changes providing for 100% participations have somewhat reduced the need for this change. However, a 100% participation in individual loans often requires the originator to remain involved in the loan, even on a limited basis. The sale or assignment of an originator's entire interest in a loan would enhance the liquidity of assets and reduce the costs attached to these types of transactions. Ultimately, producers will benefit when their lenders have increased liquidity and lower transaction costs.

We also read with interest the proposals advanced by other witnesses to expand or liberalize the Other Financing Institutions (OFI) program. AgriBank now operates a comparatively modest but nonetheless successful OFI program with 15 participating entities. We are certainly open to recommendations for improving this program and appreciate the constructive suggestions for doing so made by various witnesses. However, we believe that some of the recommended changes are either unworkable, unfair, based on a misunderstanding of the System or would require statutory change. What follows is a summary of our thoughts on some of the proposed recommendations regarding OFIs.

Capital Requirements and Equalization

We submit that the success of AgriBank's OFI program demonstrates the need for providing funding banks with flexibility. Without flexibility to control prior approval authority and advance rates, AgriBank would be unable to provide funding to the OFIs. The impression may have been conveyed at the August 3 hearing that AgriBank does not complete a portfolio review prior to establishing a lending relationship. In fact, the due diligence of OFI credit quality and credit administration are key factors in establishing the prior approval level and advance rates. By properly structuring the

credit extension, AgriBank is able to make funds available to OFIs. If this flexibility were removed, fewer OFIs would likely be approved for credit because the risk/reward equation would be unsatisfactory.

Several witnesses suggested that AgriBank's surplus equalization plan constitutes an impediment to the OFI program. It is important to understand that AgriBank's wholesale price to association and OFI customers is not a pure "market rate." Instead, it is a rate calculated, in part, on the capital accumulated from operations over decades. The capital accumulated is considerable. As of June 30, 2001, capital stock was \$548MM (36% of total equity), and surplus was \$964MM (63%). At 8%, the earned surplus provides \$77MM of revenue for Bank operations. Based on outstanding notes payable of wholesale borrowers, the \$77MM represents an equity contribution to pricing of 51 basis points (BPS). Current owners have chosen to capitalize the Bank at this level and pass the benefit of surplus on to OFIs and associations through a competitive wholesale loan rate. For example, AgriBank's average wholesale spread over cost of debt was only 15 BPS in 2001.

Surplus equalization is built on the reasonable expectation that current wholesale customers should not be required to subsidize new wholesale customers. To prevent this from happening, surplus equalization requires a new association or OFI to contribute the same level of surplus, over a 5-year period, as current wholesale customers have over a longer period of time. When approximately the same level of surplus contribution as other members is reached at the end of the five-year period, their pricing is identical to all other wholesale borrowers. An example of this equalization would be as follows:

\$964MM surplus divided by notes payable of wholesale borrowers of \$15.2 billion
= 6.34%

6.34% surplus to be recovered over 5 years = 126 BPS

plus average spread based upon cost of service = 15 BPS

Pricing to OFI for first 5 years 141 BPS

AgriBank adopted differential pricing for all our wholesale customers on January 1, 2000. Differential pricing is built on the concept of operating on a cost of service basis. It is important to recognize that AgriBank's cost per dollar loaned is not the same for wholesale customers with portfolios of \$5 billion as it is for customers with \$5 million portfolios. AgriBank uses a cost accounting process to identify various functions within the Bank and allocates expenses to each function. This method enables AgriBank to price credit equitably to customers of varied size.

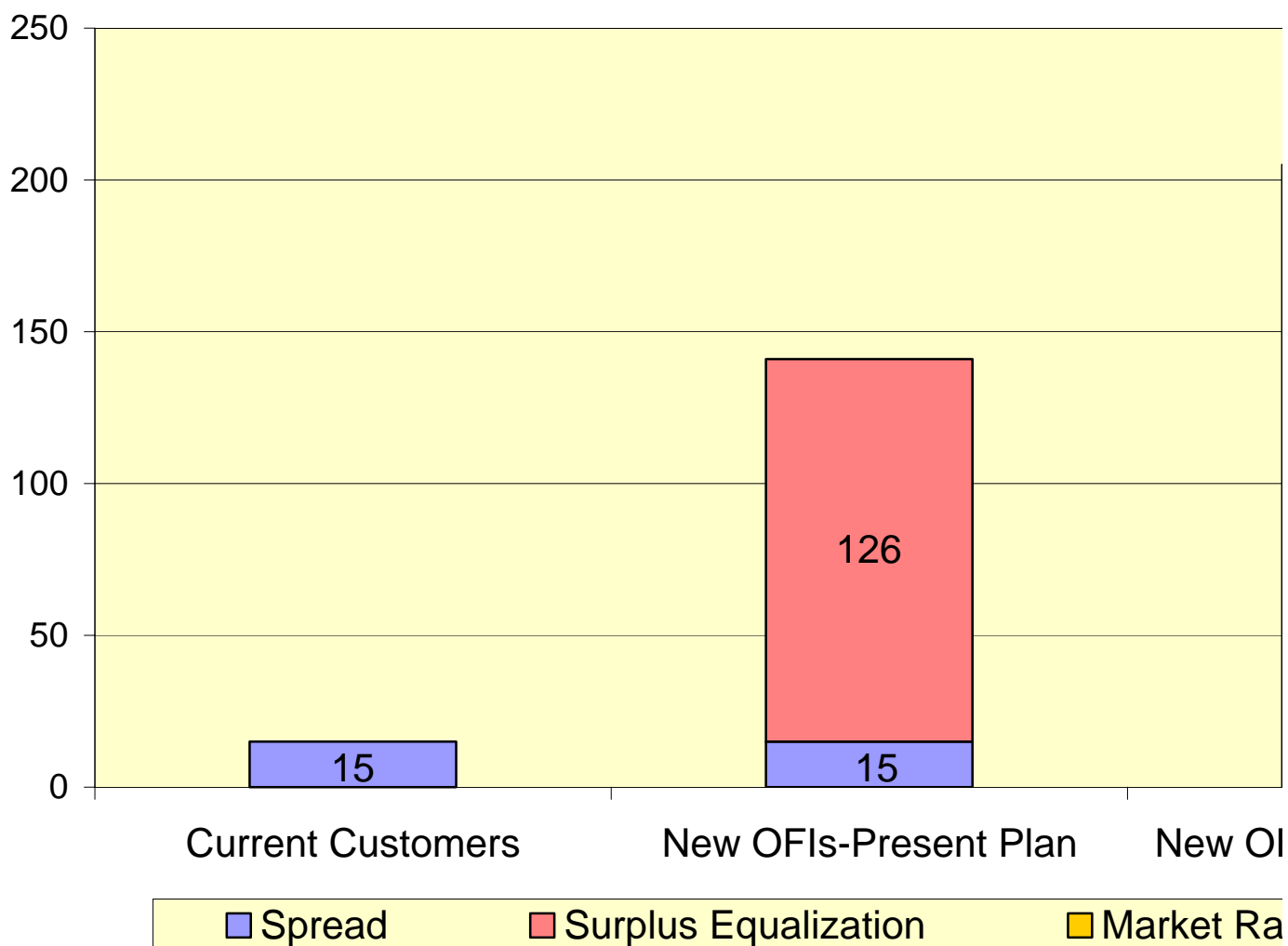
One witness correctly testified that the equalization factor does not build an equity account at the OFI. It should be noted, however, that the equalization factor brings the new associations or OFI's surplus contribution only to the same level as existing wholesale customers. This also explains the lack of any dividend payment of the "equalization factor" because all other owners do not receive dividends on the surplus. Dividends are paid on all stock and all participation certificates at the average cost of debt. The above process describes a methodology that is designed to be equitable to new and existing customers. Absent such a process, new OFIs or associations could utilize existing financial strength at the expense of current OFI and association borrowers.

A witness complained that AgriBank's capital equalization plan discourages participation by charging a premium on an OFIs' growth. The witness says that, when a new OFIs'

growth in loan volume exceeds 25% over the five year timeframe, the equalization factor is reactivated. But what should not be ignored is that the equalization factor is based on the first year's volume and no additional contributions are required unless the new OFI's volume increases by more than 25%. This arrangement provides OFIs with an opportunity to increase volume with no additional capital contribution other than the 1% participation certificate requirement. In other words, this arrangement should encourage, not penalize OFI growth.

Instead of "equitable treatment of OFIs and Farm Credit associations" as provided for in FCA regulations (§ Section 614.4590), FCBs could be required to take more of a free market approach to operating the program. However, it is very doubtful that OFIs would benefit from any such change in approach. Under a more "free market" approach, OFIs could be provided access with a stock investment of 2%, but with a price for their loan based on a market rate similar to the one charged financial companies. Most OFIs would not be rated investment grade (BBB). Market for a BB company would be priced at approximately LIBOR + 190. This would compare to our current rate of "Cost of Funds plus 15 BPS." Cost of funds is about LIBOR minus 15 BPS. Therefore, current customers are funded at approximately LIBOR flat. Because new OFIs would have limited capital at risk, patronage refunds would not be paid to OFIs. This approach would simplify the FCB's transactions with OFIs as requested by some witnesses. However, as indicated in the chart below, the long-term cost for OFIs would likely be greater under this alternative arrangement than it is under the current program.

OFI Loan Pricing



No Pre-payment Product Offerings

One witness complained that AgriBank and other FCBs currently provide limited term products and no products with pre-payment penalties. Currently, AgriBank offers 1, 2, 3, 4, 5, 7 and ten year fixed rate products and a variable rate product that is repriced monthly. AgriBank's Treasury Department is working with the OFI account officer to pursue the possibility of providing pre-payment penalty products or bullet products to

OFI customers consistent with the products provided to associations. While still in the development stages, it is anticipated that these products may be available by as early as the end of this year.

FCB Capitalization Requirements of Loans to OFIs

As indicated in our July 19, 2000 letter to the agency on OFI regulations, we support establishing the risk weighting for OFI loans at 20%, consistent with loans to associations. This would reduce the capitalization requirement of the Farm Credit Banks from the current risk weighting of 100% and increase the risk adjusted return on capital.

Real Estate Lending Authority

Testimony provided suggests that Congress did not intend to specifically exclude OFIs from access to long-term credit. We believe that the Farm Credit Act of 1971 clearly and unequivocally limits FCB funding of OFIs to short and intermediate term credit. Legislative history indicates that this limitation has been reaffirmed in subsequent congressional debate of proposed amendments to the Act. Thus removal of this restriction on FCBs to provide long-term real estate funds to OFIs would require a change in this statute.

Participation Authority

Testimony was provided that it would be advantageous to enable an OFI to participate with a Farm Credit Bank. It is clear from the testimony that different interpretations have resulted from existing regulations. We believe that, when revising the regulation, FCA should explicitly state that an FCB can participate with an OFI. We believe clarification by FCA of this authority would further enhance the flow of capital to farmers, ranchers, and producers of aquatic products.

Cross District Lending

AgriBank supports allowing OFIs to seek financing regardless of location of its headquarters. This represents a substantial liberalization of the current regulatory provision that allows an OFI to apply for funding from other FCBs only if the Farm Credit Bank in its territory denies its application. This liberalization would be consistent with FCA's board philosophy on the need for relaxing geographic-based regulatory restrictions on Farm Credit borrowers and lenders. However, we believe the regulation should recognize the right of an FCB to deny a request from or charge a premium to an OFI outside its district. Again, FCBs need to be given flexibility in their business relationship with OFIs. For example, it might be imprudent for FCBs to provide funding when it is unfamiliar with the type of agricultural production served by the OFI.

Underwriting Standards

AgriBank has developed underwriting standards for both associations and OFIs. The standards for the two are slightly different, largely in the capital component due to statutory and regulatory definitions. We support FCA's approach of requiring each bank to establish underwriting standards appropriate to the type of association or OFI financed. AgriBank provides statements of these standards and other procedures to both associations and OFIs.

Representation

Spokesman for two trade associations representing commercial banks complain about the lack of commercial bank representation on Farm Credit Bank boards of directors. One witness complained that their members have no guarantee of seats on the boards of Farm Credit Banks. According to this witness, the OFI lender/borrower relationship is "fundamentally undemocratic" when compared to the FHLB System/commercial bank

relationship. Another witness asserted that their inability to vote in the election for members of an FCB board amounts to "Taxation without Representation."

Both arguments fail to take into account that the Farm Credit System is, by statute, a "farmer-owned cooperative". Unlike the Federal Home Loan Banks, that are owned by the lending institutions which obtain loans from funds from them, farmer-borrowers are the owners of the Farm Credit System. As you know, § Section 1.1 of the 1971 Act states "as an objective of the legislation is to "continue to encourage farmer and rancher-borrowers participation in the management, control and ownership of the Farm Credit System."

This is not to say that AgriBank or other Farm Credit Banks have no interest in obtaining input from OFIs on the program. As indicated, AgriBank has an account officer who is responsible for maintaining relationships with OFIs individually and arranges for annual meetings with representatives of other financial institutions and officials of our bank. This same account officer is responsible for providing information about the program to external entities and processing the application for an OFI relationship with AgriBank.

Closing

In closing, we applaud the agency for seeking views on how the availability of agricultural and rural credit can be enhanced. We believe a number of regulatory changes by FCA can make a significant difference to agricultural lenders and producers. We believe FCS/non-FCS cooperation will be enhanced if all System institutions can purchase whole loans from non-System lenders. We think the current OFI authority can be improved by regulation but are very concerned about any change

which would limit the flexibility of funding banks to operate the program in a fair, efficient and effective manner.

Again, thank you for the opportunity to offer comments on these important questions.